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SUBJECT: TURKEY: EAST-WEST ENERGY CORRIDOR WAY FORWARD

REF: A. ANKARA 319
¶B. ANKARA 65
¶C. 05 ANKARA 7656
¶D. 05 ANKARA 7342

Classified By: AMBASSADOR ROSS WILSON FOR REASONS 1.4 (B,D)

¶1. (C) SUMMARY: Recent energy issues involving Russia, Ukraine, and Georgia have focused attention on regional transit projects via Turkey for Caspian and Middle East gas going to Southeast and Central European markets. Turkish Energy Minister Guler,s upcoming visit (REF C) to Washington offers an opportunity to focus on the policy and other issues that are key to realizing this east-west gas corridor vision. The launch of a serious U.S.-Turkey energy dialogue during Guler,s visit adds to our tools for managing these issues. A large amount of work needs to be done in Turkey itself to develop a legal and regulatory framework that encourages private sector investment in the energy sector. End Summary.

BTC as first step- First tanker end of May

¶2. (C) Expected completion of the BTC oil pipeline and first tanker at Ceyhan at the end of May will complete a key element of Turkey's role as part of the East-West Energy Corridor. Delays in completing this 1 mm bpd pipeline underscore some of the challenges Turkey and its state pipeline company BOTAS (BTC Prime Contractor in Turkey) face in further steps in developing the East-West energy bridge.

Bird in the Hand) EU and Turkey and Russia Reliance

¶3. (C) Turkey,s long-term accession to the EU offers a road map for liberalization and reform of the energy sector. Turkey will soon harmonize with the European so-called UCTE transmission grid, but did not sign the recent Brussels treaty for acceding SE countries because it seeks to negotiate special status and time-frames for harmonizing with EU directives. The EU itself has struggled with balancing

liberalization and security of supply, choosing to increase its reliance on and commercial links with Russia and Gazprom. Interruptions associated with the Ukraine face-off highlight the risks of over-reliance on Russia or any single supplier (REF B). Turkey imports two-thirds of its gas) and one-third of its oil from Russia (it imports over 90 % of its total oil and gas consumption).

BOTAS as national champion) But weak capacity
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¶4. (C) One key obstacle to Turkey realizing and further developing its East-West Energy Corridor is institutional weakness and lack of capacity in BOTAS, the state pipeline company. While BOTAS has sufficient physical pipeline capacity (or plans to create it), it lacks adequate human and institutional capacity. Although Turkey has made progress in privatizing state companies, even strategic ones, like Turk Telekom and the refinery company TUPRAS, there is no plan to privatize BOTAS or the state oil company TPAO. There is a perception that these companies need state support to function as national champion and negotiate with the likes of Russia,s Gazprom and Iran.

¶5. (C) BOTAS has suffered frequent personnel changeover at key management positions, weakening its capacity for risk-taking. For example, in the recent natural gas shortfall from Iran, the crisis immediately was escalated to the Prime Minister level, rather than the company first implementing technical algorithms for reducing gas to &interruptible8 contracts (which pay a lower price for being subject to interruption). BOTAS, institutional weakness was on display in its shortfalls in managing a range

of sub contracts on BTC (some delivered on a political basis), which led to significant delays and cost over-runs.

Is there the will to liberalize?

¶6. (C) Liberalization and privatization in Turkey,s energy sector continue to face significant delays. It is not always clear that the GOT wants to cede control of the power sector to private interests- or even the regulatory authority. In the electricity sector, the first-step privatization of the distribution company (TEDAS - with significant international interest, including American) has been delayed. Timing for the second-step state power (EUAS) company remains unclear. In the past, Turkey has often changed the rules (with successive governments), sometimes arbitrarily cancelling BOT,s, TOR,s, and other contract models (with negative impact on investment environment). Turkey faces serious problems in meeting its current and projected energy needs, so needs to attract foreign investment.

¶7. (C) Mandated privatization of BOTAS, gas import contracts has been delayed and mishandled, in effect requiring Gazprom or Iranian approval - and most recently becoming embroiled in special interests (Ref D). Liberalization in the oil exploration sector has also been delayed in favor of protecting the state champion TPAO. Natural gas distribution tenders for newly supplied municipalities have been proceeding remarkably smoothly. Turkey and BOTAS have done a reasonable job of managing an excess of gas take-or-pay commitments, relying on some flexibility from Russia.

¶8. (C) Corruption is part of doing business in Turkey, particularly related to tenders in the energy sector. There have been sequential energy corruption probes, which have rarely proceeded to convictions, but have decreased bureaucratic initiative. The Turkey-Greece inter-connector tender had to be repeated because of corruption allegations. The Blue Stream project is notorious for corruption allegations.

Whose gas will flow to Europe? The Contenders

¶9. (C) Turkey is proceeding with small steps and making big plans for transit of gas to Europe. The Turkey-Greece inter-connector is under construction (after some delays in tendering), targeting just under 1 BCM to start, with plans to increase capacity and extend a Southern Med Ring to Italy. BOTAS is a partner in the Nabucco project for proposed transit of gas to Austria and central Europe. The project has benefited from EU support for its feasibility study, but in effect competes with the Russia-Baltic-Germany pipeline project. There is a need for USG engagement to promote diversification of supply and a southern East-West energy bridge for egress of Caspian and Middle East gas.

Iran,s Giant Gas Reserves

¶10. (C) Turkish officials say the right things to USG officials (while Nabucco partners and its web-site candidly identify Iran as a key potential source for Nabucco), but admit that - long term) Turkey cannot impede links between Iran,s prodigious reserves and Europe,s growing demand (and direct contacts with Iran). Turkey has asked for USG assistance in advancing gas-to-Europe alternatives like Turkmenistan and Iraq. Iran is a difficult partner for Turkey, not at all a reliable supplier, but focused overwhelmingly on sending gas to Europe. It recently cut its daily flow to Turkey by almost 70% (technical, weather, and political reasons), cutting Turkey,s overall daily supply by almost 20% (Ref A). Turkey has taken the contract (target 10

bcm; current 4 bcm) to international arbitration over price and quality. Although Turkish officials tell us they have grounds to pursue cancellation of the contract with Iran (based on last year,s cuts), they have been unwilling to pursue that step for energy supply diversification and political reasons.

Azerbaijan,s Shah Deniz and South Caucasus Pipeline
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¶11. (C) Azerbaijan is a key contributor to our East-West Vision. The South Caucasus Pipeline will be complete by end of 2006; however, BP has told us that BOTAS is significantly behind schedule in constructing the link to the Turkish grid at Erzurum. As this is a critical first step in regional gas trade, USG should press for timely completion. Turkey has been hesitant to agree to Georgia,s request for more of Turkey,s initial share of Shah Deniz I gas, because it is Turkey,s first gas with re-export rights and it promotes security of supply. Given growing estimates of Azeri gas reserves, Shah Deniz second and third phases have great potential, but are long time frame and will feed domestic demand in the Caucasus and Turkey (and still face disagreement among partners).

A Growing Buzz about Turkmenistan as Silver Bullet?
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¶12. (C) The failure of the Trans Caspian Pipeline has created great disappointment about Turkmenistan, but Turkey and Turkmenistan discussions have rekindled hopes for Turkmen gas potential from its sizeable reserves. Minister Guler has been enthusiastic on ressurrecting this project and recently traveled to Ashgabat. (President Niyazov recently called in the American and Turkish Ambassadors to promote TCP.) Negative factors are current political/business climate in Turkmenistan, Russian influence, lack of progress on Caspian delimitation, and competing Azeri gas development, so Turkmenistan remains low probability and long time frame.

Great Interest in Iraq Oil and Gas

¶13. (C) Iraq enjoys significant oil and gas reserves. Turkish (and American) firms show great interest and experience in oil and gas exploration in Northern Iraq. Opening Iraq for business still depends on urgently needed security and clear rules for doing business (likely to await a new government). Turkey and BOTAS have been frustrated about the long-term closure of the Kirkuk-Ceyhan oil pipeline. Inshallah, this can be a key energy corridor link for oil (and gas) to Europe.

¶14. (C) Kazakhstan also has great gas potential, but it is long time frame. Its burgeoning oil development and egress issues contribute to congestion in the Turkish Straits.

North-South Linkages

¶15. (C) Turkish officials wax optimistically about north-south linkages; for example, gas from Egypt. This represents a small gas quantity, still dependent upon completion of transit capacity via Syria. Turkish officials are hopeful for gas, oil, or water links with Israel and northern Cyprus, all low probability and long time frame.

¶16. (C) Russia is part of the north-south vision. Turkey and Russia have talked regularly at high levels, but have been unable to advance a laundry list of hoped-for projects: LNG storage and processing; Samsun-Ceyhan as Bosphorus oil bypass; increase/extension of Blue Stream gas pipeline; help on launching nuclear power program, and more. There is no lack of ideas verging on wacko: Turkmenistan and revrse Blue

Stream to the Ukraine, for example. One Embassy interlocutor argued for expanding Blue Stream from Russia for gas via Turkey to Europe, because it builds on existing infrastructure, rather than prospective hardware. Of course, the idea runs counter to diversification of European sourcing.

¶17. (C) Comment and What to Talk About: Minister Guler,s upcoming visit is an opportunity to broach critical regional and other business-investment issues related to the energy sector and transit. The process of creating cross-border gas transmission infrastructure is most likely to be a bottom-up process led by private sector investors, rather than a top down process in which governments play the decisive role. Turkey's investment environment and track record have improved over the last few years, but in order to bring needed foreign energy capital and know-how, Turkey will have to strengthen independence of its regulators, establish clear tariff structures and rules, strengthen its legal/judicial structure (to assure foreign investors have parity to domestic ones) and further liberalize the natural gas and electricity sectors. The GOT has announced its intention to increase diversity in its energy mix by adding nuclear power, but it is unclear how it will be launched or financed. Another example of Turkey,s reflexive command approach is in its increasing agitation about congestion in the Bosphorus Strait and its inability to gain commercial traction for its favored Samsun-Ceyhan pipeline (Septel). Finally, the Guler meetings and bilateral energy dialogue offer an opportunity to talk about other issues of mutual interest: LNG storage/processing, nuclear power, clean-coal technology, hydrogen, renewable energy, and energy efficiency.
WILSON